Internal Revenue Service

memorandum

CC:TI-N-7426-89
Brl:JLRood

date: AUG 16 1989

to: Albert L. Sandlin, Special Trial Attorney, Southeast CC:SE

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: [redacted]

This is in response to your request for tax litigation advice dated May 30, 1989.

ISSUES

1. Whether "workforce in place" (hereinafter referred to as "assembled workforce") is an amortizable intangible asset. 0167-1300.

2. Whether "raw material contracts" (also referred to as "favorable supply contracts") are amortizable intangible assets. 0167-1300.

CONCLUSIONS

1. Assembled workforce is not amortizable because it was not purchased, or alternatively, because it represents going concern value, which is not amortizable as a matter of law.

2. We are currently coordinating this issue with Technical and will respond as soon as possible.

FACTS

On [redacted], [redacted] (Old [redacted]) was purchased in a leveraged buy-out for $[redacted] and merged into New [redacted]. The merger qualified as a liquidation under I.R.C. § 334(b)(2). Petitioner allocated $[redacted] to goodwill, $[redacted] to the assembled workforce intangible, and $[redacted] to the raw material contracts intangible. It did not allocate any amount to going concern value. Petitioner assigned useful lives to these intangibles and amortized them under section 167.

09106

The Commissioner disallowed amortization deductions for the taxable years ending [redacted], and [redacted], and proposed deficiencies in the amounts of $[redacted] and $[redacted], respectively.

[redacted] manufactures hosiery, undergarments, and polo shirts. Its operations began in [redacted] and continued without interruption after the [redacted] merger.

Petitioner uses the term "workforce in place" or "assembled workforce" to identify expenses associated with the initial hiring and training costs that would have been incurred to recruit a workforce comparable to that acquired in the purchase of Old [redacted]. In valuing the assembled workforce intangible petitioner divided its workforce into four categories--production employees, executive staff, salary staff, and hourly wage staff. With respect to the production employees, the petitioner estimated that the cost of hiring and training a new production employee was $[redacted] and that, based upon Old [redacted]'s retention rates, it would need to hire and train [redacted] employees in order to retain the same [redacted] employees working on the acquisition date. This valuation technique is known as the avoided cost method. Petitioners allocated $[redacted] to the production employee workforce and estimated a life of [redacted] years.

The three categories of staff employees were valued based upon estimates of average salary, training time, and miscellaneous expenses. The aggregate amount allocated to these three categories was $[redacted]. Petitioner assigned a [redacted]-year useful life to the hourly employees and apparently an [redacted]-year useful life to the executive and salary staffs.

DISCUSSION

Avoided Costs

Principally, "assembled workforce" is not amortizable for two reasons. First, it is not amortizable because it is based upon avoided costs, i.e., costs saved by purchasing an existing business rather than "starting from scratch". In UFE, Inc. v. Commissioner, 92 T.C. No. 88 (June 22, 1989), the Tax Court stated that avoided costs may enable a taxpayer to make an economically sound offer to purchase a business, "but it does not follow that he is paying for those costs in the purchase price."1/

1/ The Service argued that the taxpayer had undervalued the going concern value of an acquired business. It further argued that the avoided cost method was the proper technique for valuing going concern value. The court, however, rejected the Service's argument and stated that going concern value must be

The language in UFE regarding the avoided cost method is dicta because the court used the residual method to value going concern. However, this dicta illustrates the important point that avoided costs do not create assets. While the court stated that going concern value cannot be ascertained under the avoided cost approach, such analysis also logically applies to intangibles that are based upon avoided costs. In other words, even if the petitioner decided to purchase Old [redacted] because of the avoided hiring and training costs, that does not mean that it paid for those costs in the purchase price. Under the UFE approach, avoided costs do not establish the existence of an amortizable asset.

Going Concern Value

The second reason why assembled workforce is not an amortizable asset is because any value it does possess is inextricably linked to Old [redacted]'s going concern value, which is not amortizable as a matter of law. See United States v. Cornish, 348 F.2d 175 (9th Cir. 1965). This argument becomes important if the court determines that the petitioner did acquire something as a result of the avoided hiring and training costs. The court in UFE refused to use the avoided cost approach for valuing going concern because there was no evidence that the avoided costs were purchased. However, if they are representative of something that was in fact purchased, they represent going concern value. In Concord Control, Inc. v. Commissioner, 78 T.C. 742, 744 (1982), the court stated that "there is no single, exclusive method for valuing intangible assets." It also stated that no court has clearly addressed the issue of how to value going concern. 78 T.C. at n. 2. 2/

In UFE the court assumed that the bargain method, the residual method, and the capitalization method were the only methods with which to value going concern. However, Concord Control makes it clear that there is no definitive test or tests for valuing going concern. We maintain that *if* it is determined that avoided costs were (or even could be) purchased, such costs represent going concern value and are an acceptable barometer of the value of that going concern. 3/ We should not attempt to

---

calculated using one of three valuation methods -- the bargain method, the residual method, or the capitalization method.

2/ The court valued going concern under the capitalization method in Concord. The avoided cost valuation method was not an issue in the case.

3/ In Meredith Broadcasting Co. v. United States, 405 F.2d 1214 (Ct. Cl. 1969), the court defined going concern value as including "the cost reasonably associated with starting from quantify going concern value as we did in UFE, but rather simply argue that going concern value exists due to the presence of an assembled workforce.

Assembled workforce is by definition going concern value. Going concern value has been defined by several courts. For instance, the Tax Court has stated that:

> Going concern value "is bottomed on the ability of the acquired business to generate sales without any interruption because of the takeover." [Footnote omitted]. Continuity of function and generation of sales without interruption upon the change of ownership is generally the result of such factors as (1) the existence of a network of regular customers and the expectation that their patronage will continue, (2) a staff of trained employees, (3) an established routine for supplying goods and services, (4) a product line ready for sale, and (5) equipment ready for immediate use. [Emphasis added].

Fong v. Commissioner, T.C. Memo. 1984-402. See also Winn-Dixie Montgomery, Inc. v. United States, 444 F.2d 677 (5th Cir. 1971).

In V.G.S. Corporation v. Commissioner, 68 T.C. 563 (1977), the court found that the existence of various favorable business factors can contribute to the underlying going concern value of an acquired business. The taxpayer in V.G.S. acquired combined business operations that included in place and operational refineries, a pipeline, service stations, other necessary equipment, and a source of supply for crude oil. The Tax Court found that due to the existence of these factors, the business acquired by the taxpayer:

> was more than a mere collection of assets. It was rather a viable, functioning, and going concern capable of generating a profit, and New

---

'scratch' and obtaining a license, training a staff, ...". Furthermore, in Solitron Devices, Inc. v. Commissioner, 80 T.C. 1, 20 (1983), the Tax Court determined that a taxpayer purchased going concern value because it had not purchased the acquired company but rather relied on internal growth (i.e., started from "scratch"), it would have taken 18 months to 2 years to produce and market its product and from 3 to 5 years to establish the acquired company's reputation. Arguably, if the going concern value includes the cost of starting from "scratch", the avoided cost method is an appropriate method of valuation.

> Southland acquired a valuable property right as a result.

68 T.C. at 592. The added going concern value was due to the fact that these in place elements enabled the business to operate and generate a profit.

In Meredith Broadcasting Co. v. United States, 405 F.2d 1214 (Ct. Cl. 1969), the court held that part of the value of a radio station license was allocable to going concern value since:

> [s]uch amount includes the cost reasonably associated with starting from "scratch" and obtaining a license, training a staff, and the inherent value of the licenses in the conduct of a broadcasting business by a company having network affiliations. [Emphasis added].

405 F.2d at 1229. See also Decker v. Commissioner, T.C. Memo. 1987-388, aff'd, 864 F.2d 51 (7th Cir. 1988) (retention of same office building and same clerical staff indicates purchase of going concern value). See also UFE, Inc. v. Commissioner, 92 T.C. No. 88, slip op. at 16 (June 22, 1989) (going concern value described as relating to the operating relationship of assets and personnel inherent in an ongoing business).

An application of the above authority leads to the conclusion that assembled workforce represents going concern value. For instance, in Fong v. Commissioner, T.C. Memo. 1984-402, the court held that going concern was created by the presence of a number of factors, including a staff of trained employees. The same language appears in Meredith Broadcasting Co. v. United States, 405 F.2d 1214 (Ct. Cl. 1969), where the Claimes Court noted that going concern value includes the cost reasonably associated with training a staff, among other things. Moreover, this concept is implicit in Decker v. Commissioner, T.C. Memo. 1987-388, where the court found that going concern value existed due in part to retention of the same staff of employees. Finally, in UFE, Inc. v. Commissioner, 92 T.C. at slip op. 16, the court noted that going concern has been described as related "to the operating relationship of assets and personnel inherent in an ongoing business." Since assembled workforce is inherent in the going concern value of a business, it is not amortizable as a matter of law.

The petitioner may argue that amortization is permitted because assembled workforce is an asset that can be valued and lifed. Specifically, the petitioner will probably rely on the two-part factual test in Houston Chronicle Publishing Company v. United States, 481 F.2d 1240 (5th Cir. 1973), where the Fifth Circuit held that a taxpayer may amortize an intangible asset if it can show that the asset (1) has an ascertainable value separate and distinct from goodwill, and (2) has a limited useful life, the duration of which can be estimated with reasonable accuracy. This test has been cited for the proposition that whether an intangible is actually goodwill is a factual inquiry rather than a legal question. In circumstances such as the present, however, we maintain that the question of whether an amortizable intangible asset exists is a question of law.

In Houston Chronicle, the Fifth Circuit permitted amortization of a newspaper subscription list, which the Service had argued was goodwill because its value rested upon continued customer patronage. However, the case involved the discontinuance of the acquired publication upon purchase. In essence, the taxpayer was purchasing only its competitor's subscription list. We will refer to the purchase of an intangible apart from the acquisition of an ongoing business as an "isolated purchase."

Apparently, Houston Chronicle partially inspired the publication of Rev. Rul. 74-456, 1974-2 C.B. 65. The ruling states that in some unusual instances, a taxpayer may be able to establish that certain intangibles such as customer lists and insurance expirations have ascertainable values separate and distinct from goodwill and have limited useful lives. While the ruling does not specifically state that "unusual instances" means isolated purchases, the Service should attempt to limit the definition of this term to such purchases.

With respect to the customer list issue, many courts have determined that when an acquired business will continue to be operated, the customer list simply represents goodwill or is an asset so inextricably linked to goodwill that its useful life cannot be determined with reasonable accuracy. See, e.g., Finoli v. Commissioner, 86 T.C. 697 (1986); General Television Inc. v. United States, 449 F. Supp. 609 (D. Minn. 1978), aff'd per curiam, 598 F.2d 1148 (8th Cir. 1979); Meredith Publishing Company v. Commissioner, 64 F.2d 890 (8th Cir. 1933), aff'g 23 B.T.A. 150 (1931); National Weeklies, Inc. v. Commissioner, 43 F.Supp. 554 (D. Minn. 1942); Westinghouse Broadcasting Company v. Commissioner, 36 T.C. 912 (1961), aff'd on other issues, 304 F.2d 339 (9th Cir. 1962); Tomlinson v. Commissioner, 58 T.C. 570 (1972), aff'd, 507 F.2d 723 (9th Cir. 1974). The value of an assembled workforce is that it permits the purchaser to step into the seller's shoes and operate the business without interruption. Since this is the essence of going concern value, costs associated with the purchase of an assembled workforce are nonamortizable as a matter of law.

Additionally, assembled workforce should not be deemed an amortizable asset because hiring and training costs have traditionally been viewed as ordinary and necessary business expenses. Section 162 permits the deduction of all ordinary and necessary business expenses. However, section 263 provides an exception to the general rule of section 162. Under section 263, all costs incurred to create an asset separate and distinct from goodwill must be capitalized to the asset so created. Commissioner v. Lincoln Savings & Loan Association, 403 U.S. 345 (1971); Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775 (2d Cir. 1973); NCNB Corporation v. United States, 684 F.2d 285 (4th Cir. 1982). 4/

Costs incurred to hire and train employees have traditionally been deductible currently under section 162. Rankin v. Commissioner, 17 B.T.A. 1301 (1929); Knoxville Iron Co. v. Commissioner, 18 T.C.M. 251 (1959). These costs are expensed rather than capitalized under section 263 because they are general business costs which simply enhance the overall business (i.e., enhance the going concern value). As such, they cannot form the basis of an amortizable asset, which is in essence what the petitioner is attempting to do.

Nevertheless, a Claims Court opinion creates an exception to the general rule that costs incurred to hire and train employees are currently deductible. In Cleveland Electric Illuminating Company v. United States, 7 Cl. Ct. 220 (1985), the Claims Court determined that costs incurred to train employees prior to the opening of a nuclear power plant were capital expenditures. The taxpayer entered into an agreement with another company to build and share ownership of a nuclear power plant. The other company

---

4/ Some courts apply the one-year rule which is much more liberal with respect to capitalization in that expenses need not create an asset per se to be capitalizable. Modern American Life Insurance Co. v. Commissioner, 818 F.2d 1386 (8th Cir. 1987) (expenses incurred in acquiring an asset or economic interest, benefit or advantage - whether tangible or intangible - with an income-producing life extending substantially beyond the current taxable year may not be expensed in the year of payment but must be capitalized). In fact, the Service supports the one-year rule in litigation of capitalization issues. See [redacted], GCM 39,483, I-135-85 (March 5, 1986). However, unlike the capitalization test, the amortization test has not been liberalized; it still requires a separate asset. Nevertheless, it appears that the tests should be consistent; therefore, we should not argue that the one-year rule cases are distinguishable because only the separate asset test is applicable to the amortization issue. Accordingly, we should only cite to capitalization cases that apply the separate asset test. It is unlikely that the petitioner will use the one-year rule cases to support its argument because if the court uses the one-year capitalization cases to support amortization of the assembled workforce intangible, the petitioner would probably be required to capitalize all hiring and training costs prospectively.

had responsibility for constructing the new plant, but the taxpayer had to specially train some employees before the plant could open because this new plant was unique from the taxpayer's existing plants.

The court stated that the training costs had to be capitalized regardless of whether the taxpayer was deemed to have built the plant itself or to have purchased its share of the plant from the other company. 5/ If the taxpayer was deemed to have built the plant itself, the court intimated that the costs were normal start-up costs under section 195, and thus could be amortized over a 60-month period if the taxpayer had made the appropriate election. The court also indicated that if the taxpayer had purchased its interest from the other company, the training costs should be capitalized to the ownership interest. The court was not specific with respect to the asset to which these costs would be capitalized in the latter case, but suggested that maybe they should be allocated to the operating license since they were crucial in obtaining the license.

In the same case, the Claims Court determined that training costs incurred to establish a new plant that was similar to existing plants operated by the taxpayer were currently deductible. This holding was based upon the fact that the taxpayer was simply expanding its existing business rather than starting a new trade or business.

Cleveland Electric is a very narrow holding and does not apply to the instant case. Specifically, the court required capitalization only of training expenses necessary to begin a new trade or business. (Since the new plant was unique to the taxpayer's existing business, it rose to the level of a new trade or business.) With respect to the acquisition of a business, the opinion can fairly be read to mean that training costs are capitalizable only if the acquirer must personally incur them to be able to begin operating the business, so that they too are in the nature of start-up costs. In contrast, when a taxpayer purchases a going concern and need not interrupt business operations to specially train employees, any expenses incurred to hire or train employees would be normal business expenses.

In summary, we believe that [redacted] is an excellent litigating vehicle for the assembled workforce issue. The fact that the workforce is composed of production employees minimizes any value inherent in the alleged intangible. If, for instance, the workforce had consisted of highly trained professionals in a

---

5/ Presumably, if the taxpayer had purchased an ongoing business, the court would have distinguished between training costs incurred by the taxpayer during or after the acquisition and the costs saved from acquiring an assembled workforce.

tight labor market, the court might feel compelled to allow amortization even though under our position the nature of the workforce is irrelevant.

To fully exploit the good factors in the instant case, we suggest that you investigate a few items. First, find out whether the labor force for [redacted] possessed any unique skills which were difficult to obtain. Second, find out what the labor market was like on the acquisition date for employees of that type -- was it easy or difficult to find new employees? Third, find out what type of turnover rate [redacted] had with respect to these employees. If the turnover rate was normally high, there would be little advantage in purchasing the existing workforce because new people would need to be hired a short time later. In such an instance the avoided costs concept becomes illusory. All of these factors will help to minimize any value that an assembled workforce may possess and make it look less like an asset.

As noted above, we will be contacting you soon regarding the favorable supply contract issue. Additionally, the Tax Litigation Division has an Intangibles Working Group that is coordinating the litigation of intangibles on a national level. The group is particularly interested in this case; accordingly, we would like you to continue coordinating with us as the case is developed. In this regard, please contact Joan Rood at FTS 566-3442.

MARLENE GROSS

By: Richard L. Carlisle
RICHARD L. CARLISLE
Senior Technician Reviewer
Branch 1
Tax Litigation Division